

CHAPTER 5: PROJECT PHYSICAL CONDITIONS

The existing portfolio of multi-family housing projects constitutes a major asset of the Government and the Agency, but the value of this asset depends upon the quality of its upkeep. This chapter describes the responsibilities of borrowers to maintain the physical condition of the project and of the Agency to exercise appropriate oversight of these responsibilities. The chapter describes the components of adequate physical maintenance, the role of the management plan, and the performance of a physical inspection of the project.

SECTION 1: PROJECT MAINTENANCE [7 CFR 3560. 103]

5.1 PURPOSE

The Agency has issued performance standards that describe the physical condition of a properly managed project. The Agency's interest in protecting the physical condition of projects that it has financed include:

- Providing decent, safe, and sanitary housing to the occupants;
- Protecting and enhancing the security of its investment; and
- Assuring compliance with all applicable state and local laws.

5.2 MAINTENANCE REQUIREMENTS AND STANDARDS OF PHYSICAL CONDITIONS

A. Standards of Physical Conditions

Borrowers are responsible for the long-term cost-effective preservation of the housing project. The Agency has specified two types of requirements borrowers must meet:

- Performance standards for the project; and
- Procedures and systems that property managers must design and follow.

B. Performance Standards

The regulations at 7 CFR Part 3560.103(a)(3) specify the performance standards for meeting acceptable physical conditions. The performance standards are descriptive; they describe the characteristics the Agency expects to see in a particular component or system, for example:

“The housing project must have a foundation that is free of evidence of structural failure, such as uneven settlement indicated by horizontal

cracks or severe bowing of the foundation wall. Structural members must not have evidence of rot or insect or rodent infestation.”

“The housing project must have a roof that is free of leaks, defective covering, curled or missing shingles and which is not sagging or buckling.”

The performance standards have been incorporated into a physical inspection form to be completed by Agency staff during a site visit. They also have been incorporated into the certifications that accompany the management agreement for the project.

The standards include the following major categories:

- Standards that apply to the site on which the project is located;
- Standards that apply to the exterior maintenance of the building and of the common areas;
- Standards that apply to the interior of the building or buildings; and
- Standards that apply to common areas such as hallways or elevators.

C. Maintenance Systems and Procedures

Effective maintenance is partly the result of regular routines and partly the result of promptly fixing small problems before they become major ones. Proper maintenance has a direct effect on the occupants’ perception of the quality of the housing project. Therefore, the Agency requires borrowers to institute a number of systems and procedures that the borrower must describe in the project’s management plan. The requirements for a management plan are described in Chapter 3.

Several systems are part of a sound management program:

- **Preventive maintenance.** Much maintenance work can be predicted and scheduled—this is typically described as preventive maintenance. The Agency requires managers to spell out procedures for scheduling routine tasks such as garbage and trash removal, snow and ice removal, grounds upkeep, routine painting, and minor repairs. Procedures are also required for the routine maintenance of equipment consistent with service information provided by the manufacturer—bi-weekly or monthly routine oiling, adjusting, replacement of filters, safety checks of alarms, and outside lighting, etc.
- **Response to calls.** Good upkeep requires a speedy response to complaints or unforeseen problems. The Agency requires managers to establish a system for responding to tenant complaints or to unexpected malfunctions or damage, such as leaks, broken windows, etc.

- **Work orders.** Managers must know what has happened from the time a complaint has been received or a problem has been noted, to an inspection confirming the condition has been corrected. The Agency requires the project to have a work-order system that tracks the date a complaint is received, the inspection to verify the complaint, a report describing the required repair or corrective action, the assignment of the repair, the completion report, and final inspection noting satisfactory completion of the work.
- **Inspections.** Frequent, regular inspections are a major component of an effective maintenance system. The Agency requires management, at a minimum, to perform an annual inspection of each occupied unit and to inspect each unit at move-in and move-out. Inspecting a unit with the tenant at move-in and move-out establishes the condition of the unit at the time the tenant takes possession, and may help clarify responsibility for any damages that have occurred in the unit during the occupancy period.
- **Energy conservation.** Energy conservation efforts are an ongoing responsibility of project management. The Agency requires managers to establish effective systems to reduce energy consumption. These may include energy audits to determine cost-effective techniques of energy conservation, energy efficient lighting, water saving fixtures, low-flow toilets, energy efficient appliances, insulation, caulking and weather-stripping, storm doors and windows, and regular cleaning and replacement of filters and other equipment.
- **Tenant Damages.** The Agency requires management to establish a policy and implement a system to obtain reimbursement for damage caused by the tenant to the property beyond normal wear and tear. The policy is to be stated in the tenant's lease as described in Chapter 6, **Attachment 6-B**.
- **Accessibility Issues.** The Agency requires the borrower and/or management to establish a policy regarding project and unit accessibility for applicants, tenants, and employees in accordance with applicable Civil Rights legislation.
 - ◇ In projects that were ready for occupancy on or before January 26, 1993, when public areas are altered, they must be altered to ADA/AG standards. (Public areas are those areas used by individuals other than tenants and their guests. This includes offices used to pay bills or to inquire about service or employment, public restrooms, and buildings used for voting or public meetings.)
 - ◇ In projects that were ready for occupancy after January 26, 1993, public areas must be designed and constructed to ADA/AG standards.
 - ◇ In accordance with the Fair Housing Act, in multi-family housing projects that were ready for occupancy on or before March 31, 1991, FHA/AG architectural requirements do not apply, even during project rehabilitation.

- ◇ In Accordance with the Fair Housing Act, in multi-family housing projects that were ready for occupancy after March 13, 1991:
 - ◆ All first floor ground units in buildings with four or more dwelling units must be designed and constructed in a manner that is adaptable to individuals with disabilities.
 - ◆ All units must be adaptable if there is an elevator.
 - ◆ Covered multi-family housing projects must have:
 - ✓ An accessible entrance on an accessible route;
 - ✓ Accessible public and common-use areas;
 - ✓ Usable doors;
 - ✓ Accessible routes into and through the dwelling unit;
 - ✓ Accessible light switches, electrical outlets, and environmental controls;
 - ✓ Reinforced bathroom walls; and
 - ✓ Usable kitchens and bathrooms.

The site visit form (see Appendix A) includes space for servicing staff to comment on the adequacy of the maintenance systems adopted by project management.

D. Requirements for Labor Housing

There are no separate performance standards for year-round labor housing and rental or cooperative housing. Seasonal labor housing must meet conventional performance standards and must have insulation as necessary to protect the facility during the off-season period.

5.3 CORRECTING DEFICIENCIES

A. Overview

The borrower is responsible for adequate maintenance and upkeep of the project that complies with Agency performance standards. The Agency expects the borrower to correct any deficiencies in the project's physical condition as soon as the problem is identified. The borrower shall inform the Agency immediately of any deficiency for which correction requires repairs that cannot be paid out of project operating funds. The borrower shall provide the Agency with a time frame for completing the repairs, and immediately initiate procedures to access project reserves (see Section 2).

There are a number of ways in which the need for maintenance is identified:

- Management staff may uncover, anticipate, or expect such maintenance;
- Tenants may make complaints; and
- Agency staff may identify defects in the course of a site visit.

No matter how the problem was identified, the borrower is responsible for correcting it.

5.4 PAYING FOR MAINTENANCE EXPENSES

Maintenance is paid for in two ways:

- Routine physical maintenance such as repainting an empty unit, replacing a broken window, snow removal, or grounds upkeep is part of the operating budget and paid for out of annual operating income.
- Major capital expenditures are paid for by withdrawals from the reserve account. Capital expenditures are addressed as “long-term improvements” on the front of the operating budget.

The next section of this chapter describes the process for accessing the reserve account to pay for major capital improvements.

Rule-of-Thumb

A capital expenditure is typically defined as an expenditure on an item for which the useful life is greater than one year. For example:

- Repaving the parking lot is a capital cost; fixing a pothole is an operating cost.
- Painting is more difficult to classify. Repainting the exterior of the entire project is a capital expenditure; interior repainting could be either.

SECTION 2: USING RESERVES FOR PHYSICAL MAINTENANCE

5.5 ELIGIBLE USES

With prior written consent of the Agency, the borrower may use reserve account funds:

- To pay for repairs to housing, furniture, or equipment damaged by long-term depreciation or emergencies; or
- To make permanent improvements to the housing project, such as installing an energy-conserving heat pump or making a unit accessible to persons with disabilities.
- To meet an emergency shortfall in operating expenses when the emergency is beyond the control of the borrower and threatens life, safety, or the physical security of the project. Examples might include an extreme weather disaster or reductions in rental income caused by changes in the rental market that affect other housing projects as well.

5.6 PLANNED USE OF RESERVES

The Agency expects borrowers to anticipate and plan for major capital expenditures at least annually. The borrower is required to submit an annual capital expenditure budget as part of the annual budget submission. The Loan Servicer reviews these documents, as well as the annual report of actual expenditures to ensure that the borrower includes expenditures adequate to maintain the property to Agency standards. This should include plans to catch up with any maintenance expenses deferred from previous years, or to correct any deficiencies identified during Agency site visits.

The borrower must submit a written request to the Agency to use reserve funds, even if the Agency has reviewed and approved the capital expenditures in its review of the Annual Capital Budget. The borrower must obtain cost estimates for proposed repairs/replacements.

5.7 UNANTICIPATED USES OF RESERVES

The Agency recognizes that not all capital expenditures can be predicted a year in advance. Sometimes a major piece of equipment will break down unexpectedly, or a severe storm will create damage. Borrowers must seek Agency approval for the unforeseen use of reserves. In emergency situations when the borrower can demonstrate an imminent and serious threat to the health, safety, or physical security of the project, the borrower may request the Agency to post-approve the use of reserves. The Agency will only approve emergency withdrawals if the reserves were used for eligible expenses.

The Agency may approve a borrower's request to increase the required level of the reserve account to ensure sufficient funds are available to address capital requirements of a transition plan. The use of reserve funds to address the capital requirements identified by the borrower's transition plan may be considered an authorized use of reserve account funds. Loan funds may also be used for this purpose.

5.8 THE WITHDRAWAL PROCESS

A. Common Procedure

The procedures the borrower and the Agency use vary with the complexity and cost of the project for which reserve funds are sought. However, some steps are used in all cases:

- The borrower writes the Field Office to request the use of reserve funds for a capital expenditure. The letter must include:
 - ◇ A statement of the purpose and a description of the item for which reserves will be used;
 - ◇ A certified reserve account statement that shows the current balance in the account and other activity such as deposits and withdrawals;
 - ◇ The estimated cost of the item;
 - ◇ Documentation of compliance with procurement requirements (including copies of bids, as necessary);
 - ◇ A copy of the approved capital budget that included the item, or an explanation of why the item was not included in the annual capital budget; and
 - ◇ A statement of the current balance in the reserve account.
- The Servicing Office reviews the request:
 - ◇ If the request is for an item—other than a substantial construction activity—that was included in the annual capital budget and approved during the Agency review of the engagement report, the Servicing Office must complete its review within five calendar days.
 - ◇ If the request is for a capital expenditure that is not an emergency, and was not part of the annual capital budget, the Servicing Office has 30 calendar days to complete its review.
- The Servicing Office notifies the borrower in writing of the decision to:
 - ◇ Approve the request;
 - ◇ Approve the request with conditions; or
 - ◇ Deny the request (this must include the reasons for denial and an explanation of the borrower's appeal rights).

- The borrower submits a request for payment, supported by an invoice and accompanied by a two-party check made out to the vendor or contractor.

B. Non-Construction Activities

These are activities for which reserves will be used to purchase or replace capital goods, such as stoves and refrigerators, which involve no modification to the structure of the project. Borrowers often obtain bulk prices for these items, which are good for a year. In obtaining these prices, the borrower must comply with the procurement requirements of the Agency, described at XXX.¹

C. Projects Involving Moderate Levels of Construction

These are projects that do not involve any substantial changes to the structure or replacement of major systems, and which cost less than \$100,000. Examples could include exterior re-painting, roof repair, parking lot re-paving, and repairs to plumbing or electrical systems. When the borrower requests access to reserves for a moderate construction activity, the Agency first reviews the construction documents and then reviews a payment request.

In addition to the items specified in paragraph 5.8 A, the borrower must provide:

- The specifications for the activity and of the work to be performed;
- Copies of written bids received by the manager if the cost exceeds \$5,000;
- A rationale for awarding the contract; and
- A copy of the construction contract.

Once the item has been approved, the borrower submits a request for payment, supported by an invoice and accompanied by a two-party check made out to the vendor or contractor.

D. Larger Construction Items

These activities involve substantial changes to the structure, replacement of major systems, or expenditures in excess of \$100,000. Such activities are subject to the construction requirements of RD Instruction 1924-A, Planning and Performing Construction and Other Development, including:

- A detailed description of the project, including specifications and drawings;
- A copy of the bid documents;
- A copy of the construction contract once the Agency has approved the bidding process.

Once the construction contract has been approved by the Agency, the borrower may request an initial draw to pay for materials or make a down payment to the contractor. The request for an initial draw should be accompanied by invoices and a check made out to the contract or vendor, to be cosigned by the Agency. The Agency may approve such a request provided the amount of the initial draw does not exceed a reasonable percentage of the value of the construction contract. All such payments shall include appropriate Agency retainages.

The Agency will inspect the project before approving the work and again at construction completion, before approving the final draw. The purpose of the initial inspection is to establish that the proposed work is needed and is an appropriate response to existing conditions. The purpose of the final inspection is to establish that the work was performed as approved by the Agency and according to Agency construction standards. The Agency may conduct additional inspections as it sees fit.

E. Projects Involving an Identity-of-Interest Between Borrower and Contractor

Where there is an identity-of-interest between the borrower or property manager, and the contractor or vendor, bids will be required for all expenditures from reserves that exceed \$2,500 annually. The entity with the identity-of-interest must submit its bid directly to the Servicing Office, prior to requesting bids from other firms. The Agency requires at least two bids from other firms, or an explanation of why the borrower was unable to obtain two bids.

SECTION 3: CAPITAL PLANNING

The purpose of this section is to describe how borrowers, with assistance from Agency staff, anticipate the need for major capital expenses and plan how to pay for them. This type of planning can take many forms. The two most used by the Agency are an annual capital expenditure budget and a lifecycle cost analysis.

5.9 ANNUAL CAPITAL PLANNING

A. The Role of the Borrower

The borrower identifies major maintenance and replacement needs during the annual budget cycle and develops a schedule for making withdrawals from the reserve account to pay for their cost. These plans are incorporated by the borrower into the annual capital expenditure budget, and may also be reflected in the operating budget if some work can be paid for out of operating income.

B. Agency Review

The Loan Servicer uses the budget cycle to assess the borrower's annual capital plan and to assist the borrower, as necessary, to plan for additional improvements to the project's physical condition.

The Loan Servicer reviews the operating and capital budgets, and compares them with previous budgets, site visit reports, and audit reports. When doing so, the Loan Servicer should consider the following questions:

- Are expenditures sufficient to maintain the project according to the Agency's performance standards and the requirements of the project management plan?
- Were any essential items of maintenance deferred during the past year, which should be financed from the upcoming operating or capital budget?
- Are there any uncorrected defects noted in site visit reports that should be financed from the upcoming operating or capital budget?

If the Loan Servicer finds the operating and capital budgets inadequate to keep the project in compliance with performance standards, the Loan Servicer must request the borrower to modify the annual capital plan. The Loan Servicer may also request modifications, if it is found that the borrower has proposed expenditures to be paid from reserves that should be charged to the operating account.

5.10 CAPITAL NEEDS ASSESSMENT

A. Overview

The Agency encourages borrowers to develop a capital needs assessment for each project, based on an analysis of the life-cycle of major building components and systems,

equipment, and exterior elements such as the building's facade, driveways, and parking lots. The capital needs assessment includes a replacement analysis that anticipates the useful life of each of these items, estimates the point at which they will need to be replaced, and the cost of their replacement. Preparation of this capital needs assessment is an eligible project expense, provided the assessment is reasonable in cost and meets Agency requirements.

B. Required Skills

Preparation of a capital needs assessment usually requires the services of:

- An engineer and/or architect who inspects to assess the expected life of building systems and who develops the initial replacement analysis; and
- An expert in finance who can project the level of reserves, including accumulated interest, the replacement budget will require.

In some instances the services of a cost estimator may also be needed. Experienced property managers usually can accurately estimate the point at which various types of equipment need to be replaced.

C. When Capital Needs Assessments are Required

1. Projects Funded After 1997

Beginning in 1997, the amount required for deposit into the reserve account will be calculated for newly funded projects during the loan origination phase, using a life-cycle analysis based on a review of the materials going into the project and its major design features. For information on conducting life-cycle analyses, please refer to Chapter 3 of the Loan Origination Handbook.

2. Other Projects

While the Agency encourages the development of a capital needs assessment, such a plan is required only in the following circumstances:

- When ownership of the project is transferred;
- When the loan is reamortized; or
- When there is a write-down of the project loan;

D. Agency Review

Capital needs assessments are submitted to the Field Office for Agency review. This review may cause changes in the level of annual contributions the borrower is required to make to the reserve account.

SECTION 4: AGENCY OVERSIGHT OF BORROWER PERFORMANCE

5.11 OVERSIGHT DURING DESIGN AND CONSTRUCTION

A. Design Review

Agency oversight of the borrower's capacity to maintain the physical project in compliance with its standards and requirements begins during the loan origination phase. As part of its design review, the Agency examines plans and working drawings to see whether the project has been designed for easy maintenance and long-term durability.

Borrowers must describe the systems and procedures that will be used to maintain the project during the occupancy period in the Management Plan. Agency staff review the proposed management plan for compliance in accordance with procedures described in Chapter 3 of this handbook. The reviewer should analyze the description of the maintenance systems in the management plan, noting any points that appear unrealistic, incomplete, or incorrect.

5.12 OVERSIGHT DURING THE FIRST YEAR OF OPERATION

Projects in the first year of operation are subject to intensive oversight by the Field Office. The borrower must file frequent reports and Agency staff conduct two site visits, one within 90 days of initial occupancy and the second within 12 months of the first. These visits can be used by Agency staff to establish that management has installed the procedures and systems the Agency requires for project maintenance.

The construction contractor or the suppliers are usually still responsible for correcting physical defects that may emerge during this phase. The Agency holds the borrower responsible for ensuring the correction of any such defects.

5.13 ANNUAL OVERSIGHT

A. Financial Reviews

The Servicing Office reviews project finances at least twice each year:

- It reviews the proposed budget for the project.
- It reviews the annual financial reports.

These reviews provide Servicing Office staff with an opportunity to establish whether appropriate expenditures for maintenance occurred during the year just completed and are projected for the coming year.

During the budget review, the Servicing Officer checks whether the operating budget and the annual capital budget proposed for the coming year appear adequate. The Servicing Officer may use comparisons with projects of similar size and age, site visit reports and other project records, and the long-term capital plan to determine whether

there are outstanding findings that require additional improvements to the physical condition of the project.

The review of the annual financial report provides final information on actual expenditures for physical maintenance in the completed fiscal year, and identifies any discrepancies between budgeted and actual expenses for this purpose. Instances of deferred maintenance should be followed up with project management.

B. Annual Physical Inspection

The Field Office will conduct an annual physical inspection, known as a “walk-about,” in the year between formal physical inspections. This review does not require prior notice to the borrower or manager. Its purpose is to determine, quickly, that project maintenance complies with Agency requirements. If the Field Office notes any maintenance problems, staff will schedule a follow-up physical inspection

During the review, staff from the Field Office checks and photographs exteriors, sites, and public spaces of the project. Staff should review the inspection package the Agency has developed prior to making the site visit. The package includes an explanation of how each component of the physical plant relates to tenant health and safety, and a description of the performance standard for each component. The major components to be reviewed are listed in Exhibit 5-1. These are the items listed under the “Exterior/Inspection” section of the Physical Inspection form.

Exhibit 5-1

Major Components to be Inspected at an Annual Physical Review

- Utilities
- Drainage and erosion control
- Landscaping/grounds
- Drives, parking areas, walks
- Exterior signs
- Fences and retaining walls
- Debris and graffiti
- Exterior lighting
- Foundation
- Exterior walls and siding
- Roof, flashing, gutters
- Windows, doors, and exterior structures
- Common area accessibility
- Common area signs

The inspection form includes a section in which the results of these inspections are noted. If the review indicates there are major problems or deficiencies at the site, the Field Office will schedule a full-blown physical inspection of the project. The walk-about is intended to take no longer than a half hour to complete. Its primary purpose is

not to inspect for full compliance with all applicable maintenance standards, but to identify any potentially serious problems that require immediate attention.

C. Three-Year Physical Inspection

The Field Office must schedule and perform a formal physical inspection of each project at least once every three years until the loan is repaid in full. In addition, the Field Office makes physical inspections to projects that are delinquent or evidencing problems. The purpose of physical inspections is to allow the Agency to view the physical conditions of a project firsthand and make sure the property and its buildings are being maintained according to Agency standards. The procedures for completing a physical inspection are discussed further in Chapter 9, paragraph 9-12.

1. Pre-Inspection Actions

Prior to the inspection, the Loan Servicer reviews project files to note any previously identified maintenance issues and reviews the annual budget and annual financial report to identify instances of deferred maintenance. Prior site visit reports, annual budgets for capital expenditures, and any long-term capital plans are key documents for this review.

2. The Site Visit

The Loan Servicer performs a physical inspection of the project exterior and of a sampling of occupied and vacant units. Performance standards for project maintenance have been incorporated into the project inspection form. Staff should review the inspection package the Agency has developed prior to making the site visit. The package includes an explanation of how each component of the physical plant relates to tenant health and safety, and a description of the performance standard for each component. The major components to be examined are listed in Exhibit 5-2.

The Servicing Official uses the inspection form to note whether each performance standard has been met, and to add other comments.

Exhibit 5-2**Major Components to be Examined in a Physical Inspection**

Exterior	Interior
<ul style="list-style-type: none"> • Utilities • Drainage and erosion control • Landscaping/grounds • Drives, parking areas, walks • Exterior signs • Fences and retaining walls • Debris and graffiti • Exterior lighting • Foundation • Exterior walls and siding • Roof, flashing, gutters • Windows, doors, and exterior structures • Common area accessibility • Common area signs 	<ul style="list-style-type: none"> • Flooring • Walls, floors, and ceilings • Doors and windows • Electrical, AC, and heating • Water heaters • Smoke Alarms • Emergency Call Systems (if applicable) • Insect/vermin infestation • Range and hood • Refrigerator • Sinks • Cabinets • Water closet • Bathtub and shower stall • Fully accessible units

3. Monitoring Borrower Compliance with Physical Accessibility Requirements**4. Analyzing and Categorizing Inspection Findings**

The Agency recognizes that not all failures to meet performance standards are of equal magnitude. It has established guidelines for rating the seriousness of defects ranging from Levels I through III, in which Level I is the most serious, constituting a major threat to health and safety. The inspection package includes an explanation of these levels and categorizes performance standard deficiencies by level.

- Projects with Level III defects have minor maintenance items that can be corrected within a month; during this period the project may continue to receive federal subsidies.
- Projects with Level II defects require some major maintenance that can be performed within six months; during this period the project may continue to receive federal subsidies.
- Projects with Level I physical defects are not considered eligible for federal subsidy. Level I physical defects that are not corrected immediately, may affect the health and safety of tenants. Because of the serious consequences of this designation, this rating can only be given after review and concurrence by the State Director but federal subsidy cannot be terminated until the borrower has exhausted all appeal rights.

ENDNOTES

¹ RHS: What reference should we include here for procurement policies?